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Eleanor Dart

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UK INVESTORS' PERCEPTIONS OF AUDITOR INDEPENDENCE

Abstract

The purpose of an auditor's role in society is to validate the truthfulness of financial statements. In order to perform their role, it is essential that auditors are independent of the client company and are not seen to have any motive for non-disclosure of misleading information (Lavin, 1977:237). If owners of organisations doubt the auditor's independence, financial statements will lack credibility. However, despite independence lying at the heart of the auditing profession, independence concerns can be traced back to the 19th Century. During this time the accounting profession has found it difficult to produce a system of standards which eliminate conflicts of interest and protect auditors' independent mental attitude. In the UK, auditor independence concerns were heightened as a result of the scandals and corporate collapses which took place in the 1980s and 1990s (e.g. Maxwell, BCCI, Polly Peck, Barings Bank and Lloyd's of London). Since these scandals, much has changed in the 'environment within which auditing services are bought and sold' (Beattie and Fearnley, 1994:301), including the concentration of the audit market from the Big Eight auditors to the Big Four auditors and yet another, more recent, wave of high profile accounting scandals (e.g. Enron and WorldCom). Such changes have provoked new audit regulations. For example the Sarbanes-Oxley Act (2002) in the USA and the Auditing Practices Board's (2004) 'Ethical Standards for Auditors' in the UK.

This questionnaire-based study conducted in 2005 focuses specifically upon how investors perceive some of the main auditor-client relationships that may have contributed to the collapse of Enron: the joint provision of audit and non-audit services, an audit firm's economic dependence upon a client and long relationships between auditors and clients, in order to determine whether, in the current climate, owners still have faith in the role of the auditor. The results suggest that, similar to previous UK perceptions based work (e.g. Firth 1980, 1981), economic dependence and the provision of non-audit services are perceived as greater threats to auditor independence than a long auditor-client relationship. In general, private investors and those without accounting qualifications displayed the most concern about auditor independence issues. However, all investors perceived the current 'Ethical Standards for Auditors' as sufficient safeguards for their investments and indicated that the introduction of further regulation was not necessary.

UK INVESTORS' PERCEPTIONS OF AUDITOR INDEPENDENCE

INTRODUCTION

The auditors' role in society is to validate the truthfulness of financial statements. In order to perform their role, it is essential that auditors are independent of the client company and are not seen to have any motive for non-disclosure of misleading information (Lavin, 1977:237). If owners of organisations doubt the auditors' independence, financial statements will lack credibility, which could lead to the 'abrupt and arbitrary withdrawal of capital from suspect businesses' (ABI, 2002:3). However, despite independence lying at the heart of the auditing profession, independence concerns can be traced back to the 19th Century. Since this time the accounting profession has found it difficult to produce a system of standards which eliminate conflicts of interest and protect auditors' independent mental attitude. In the UK, auditor independence concerns were heightened as a result of the scandals and corporate collapses which took place in the 1980s and 1990s (e.g. Maxwell, BCCI, Polly Peck, Barings Bank and Lloyd's of London). The responses to these scandals most commonly involved some changes to the structure and pronouncements of regulatory bodies. Academic interest in auditor independence has been quite substantial (see for example Firth, 1980 & 1981, Shockley, 1981, Dykxhoorn & Sinning, 1982, Pany & Reckers, 1983 & 1984, Knapp, 1985, Lindsay, 1987, 1989 & 1990, Gul, 1991 and Wines 1994).

In recent years, much has changed in the 'environment within which auditing services are bought and sold' (Beattie and Fearnley, 1994:301). Since 1987, there has been a

series of mega mergers of audit firms, meaning that the Big 8 audit firms were reduced to the Big 6 and more recently with the collapse of Andersen in 2002 to the Big 4. It is argued that this more concentrated audit market may have an impact on auditor independence and on the quality of audits. Pong (1999) argued that limited audit firm choice might increase conflicts of interest for auditors as it is likely that with fewer audit firms to provide consulting, situations where audit firms provide non-audit services to their audit clients will increase.

The recent wave of high profile accounting scandals has also dramatically changed the modern audit environment. In 2001, Enron, America's 7th largest company, collapsed after it was revealed that profits had been overstated by \$600m since 1997. WorldCom and Tyco followed the collapse of Enron, refocusing world attention on the role of the auditor. As a result of these scandals the Sarbanes-Oxley Act 2002 was introduced in the USA to ensure that auditors would be seen to be in a position of complete independence. Among the requirements of the Sarbanes-Oxley Act was the banning of nine types of non-audit service and the compulsory rotation of partners in the audit engagement team every five years.

The high profile accounting scandals in the USA also provoked a reaction from UK regulators. In 2004, the Auditing Practices Board issued 'Ethical Standards for Auditors' (updated in 2008). These standards are less permissive than previous guidelines and must be followed by all members of professional accounting bodies who engage in auditing activities. The standards include a 10% limit on audit firm income from any one listed company client, audit engagement partner rotation every 5 years and key audit personnel rotation every 7 years and compulsory withdrawal from

the audit should any non-audit services supplied not be viewed as consistent with the objectives of the audit itself.

However, despite these developments, fundamental questions over auditors' ability to live up to the service ideal of professional integrity still remain and there is much controversy over what can be done to 'minimise the possibility of an Enron or WorldCom situation occurring' (Reeves, 2002:4). Whilst it appears that 'no single solution is a panacea' (Reeves, 2002:4) for UK auditor independence concerns, interested parties have yet to agree upon important issues such as whether non-audit service provision should be prohibited or whether a system of mandatory audit firm rotation should be introduced. It is clear that further consideration may be needed to prevent future losses of confidence in auditor independence.

Against a back-drop of high profile corporate collapses and further concentration of the UK audit market, the current study offers a timely and relevant insight into how owners of organisations, one of the main users of audited financial information, perceive auditor independence. This questionnaire-based study conducted in 2005 focuses specifically upon how investors perceive some of the main contentious auditor-client relationships: the joint provision of audit and non-audit services, an audit firm's economic dependence upon a client and long relationships between auditors and clients. The study will determine whether, in the current climate, owners still have faith in the role of the auditor and whether they perceive the current Ethical Standards for Auditors as sufficient safeguards of their investments. Perceptions of how auditor independence can be further enhanced are also examined. It is argued that methods to enhance auditor independence have previously been overlooked by

researchers (Beattie et al., 1999 & Alleyne and Devonish, 2006). The study also provides a unique insight into the differences in perceptions of institutional and private investors. A comparison between the two groups will determine whether different motives for investing and differences in accounting background determine how the two groups view auditor independence. This unique focus upon the differences between private and institutional investors is the only known UK study of its kind.

The study builds upon previous UK perceptions-based work conducted prior to the high profile corporate collapses in the USA by Firth (1980, 1981) and Beattie et al. (1999). Such a comparison will be insightful in determining whether the recent corporate scandals have damaged UK investor perceptions of auditor independence, or whether the owners of UK organisations still have faith in auditors. As the audit market has changed quite substantially since these studies were conducted (fewer audit firms, increases in audit failures and the rise in non-audit service provision over the last 20 years), it is expected that perceptions of auditor independence may differ from those recorded by Firth (1980, 1981) and Beattie et al. (1999). The research is of value to those academics and accounting professionals currently debating the role of the auditor and to those policymakers considering UK accounting regulation.

In the wake of a series of high profile accounting scandals and the resultant changes in the landscape of the audit market, it is the objective of the current study to address the following research questions. Do investors have faith in the independence of auditors? How do they perceive three of the most controversial auditor-client relationships: an auditor's economic dependence upon a client, long association

between auditor and client and an audit firms' joint provision of audit and non-audit services? In order to address gaps in the current literature, the study also sets out to determine investor perceptions of current and proposed safeguards to protect auditor independence.

The remainder of the paper is organised as follows: the next section examines the literature in the areas of economic dependence, non-audit service provision and long tenure. From this review, hypotheses will be developed. The methodology and survey design will then be discussed, followed by the results and conclusions of the research.

LITERATURE REVIEW

The following section provides an overview of the research into auditor independence and in particular economic dependence, the provision of non-audit services and long tenure. The auditor independence literature is vast, therefore only those studies most relevant to the research questions are included.

Economic Dependence

The amount and method by which audit fees are paid to audit firms can create a conflict of interest for auditors. Mautz and Sharaf (1961:211) identified how audit fee payment could impair third party perceptions of independence, 'it is a fact of life in public accounting that fees come from clients, and public accountants are directly dependent on business companies for the greater part of their revenues. An intimate association with business is so obvious a characteristic of public accounting and

auditing that we fail to see its influence on the minds of laymen'. Markelevich et al. (2005:7) note that large fees paid to the auditor could result in the auditor becoming 'reluctant to make appropriate inquiries during the audit for fear of losing highly profitable fees'.

In the case of Enron, it has been argued that 'even without the additional revenue from non-audit services as a reason for Andersen to relax its professional judgement, as some have alleged, the audit fees paid to Andersen by Enron represented a substantial portion of the revenue of the servicing office' (Haber, 2005:12). Moreover, Francis (2006:749) asserts that 'all fees create a fee dependence on the client' and that 'a completely independent audit is, by definition, impossible due to the fee dependence inherent in audit contracting'. Beattie et al. (1999:71) argue that incentives to compromise independence, because of fee dependence, 'can operate at firm, office and partner levels'.

In an early perceptions-based study, Firth (1980) mailed a questionnaire to 750 users and preparers of financial statements to determine perceptions of 29 different auditor-client relationships. In relation to fee dependence, the participants were asked how the two following situations affected their perceptions of auditor independence:

- An accounting firm receives 15% of its gross fees from one client,
- One large office of a national accounting firm receives 20% of its gross fees from one client.

In both situations a significant amount of respondents believed that auditors would lose their independence, with the financial analysts and the loan officers (the users of financial statements) showing more concern than the CPAs. The study was extended by Firth (1981) to examine how bank loan officers would react to certain auditor-client relationships, one of which being an auditor receiving 15% of gross fees from one client. The results showed that in this situation, the mean loan offered by the bank officers was significantly lower than that offered for the 'independent relationship'. Furthermore, in a study of Canadian bankers, financial analysts and auditors, Lindsay (1987) found that all of the groups perceived a situation where an audit firm received 15-16% of total income from one client as a major threat to auditor independence. Gul (1991) reports similar concerns in a study of New Zealand bankers.

In an extension of Firth's work (1980, 1981) Bartlett (1993) examined how the size of the audit fee could affect commercial lending officers and CPA's perceptions of auditor independence. Participants were asked to rate how independent they believed an audit firm to be when the audit fee from one client represented 1% of total CPA firm revenue and when an audit fee from one client represented 40% of total CPA firm revenue. The results showed that the 1% case was rated much higher in perceived independence than the 40% case. Given the knowledge of the size of the audit fee, there was an insignificant decline in CPAs' perceptions of independence, and a significant decline in bankers' perceptions of auditor independence. Accountants were much more confident in an auditor's independence than the bankers were. Furthermore, Teoh and Lim (1996) found that large audit fees received from a single audit client affected auditor independence perceptions of Malaysian accountants.

Bartlett (1997) examines perceptions of auditor independence in relation to (implied) economic dependence. A sample of CPAs and bankers were presented with a case study which outlined a client who provided a substantial part of the audit firm's fee base. The respondents were asked to rate how likely a CPA partner was to make an adjustment which would increase the client's bad debt expense in light of the CPA's economic dependence. Over 70% of both groups believed that the auditor would perceive the adjustment to be necessary and that 'the CPA would be able to make an independent decision regarding the required adjustment in spite of the overall size of the audit fee to the individual partner' (Bartlett, 1997:253). Finally, those who believed that the auditor would resist client pressure gave as their main reasons: the CPA's professional ethics, the threat of lawsuits and the damage to audit firm reputation.

However, Bartlett (1997) acknowledged that due to the sensitive nature of some of the questions (especially for the CPAs who had to judge the honesty of other people in their profession) the participants may not have answered truthfully.

In Beattie et al.'s (1999) study, finance directors and audit partners expressed the most concern for auditor independence when an individual audit partner's income depended on retaining a certain client, rather than at the office or firm level. In a similar study based in Barbados, Alleyne and Devonish (2006) found that users and preparers of financial statements ranked economic dependence as a significant risk to auditor independence. It was also found that auditor size affected perceived auditor independence.

The size of the audit firm is often considered when examining the issue of fee dependence. For example, DeAngelo's (1981) economic model states that incentives for an auditor to compromise independence will be a balance between the importance of the client and the litigation and reputation costs which could result from breached auditor independence. DeAngelo (1981) argues that smaller accounting firms may have bigger incentives to compromise independence than larger accounting firms as smaller firms have fewer clients and so each client represents a larger proportion of income to the auditor.

Reynolds and Francis (2001) examine the size of the client rather than the size of the audit firm arguing that larger clients could create greater economic fee dependence than smaller ones, leading to 'preferential treatment and favourable reporting by auditors' (Reynolds and Francis, 2001:379). Losing a large client may have extreme effects on the local audit office, resulting in a big reduction in revenue and lower partner compensation. Reynolds and Francis (2001) examine the accruals of 6,747 US companies that had Big Five auditors in 1996. However, the examination shows that 'neither the office-level analysis nor national-level analysis find evidence that economic dependence causes auditors to be lenient and report more favourably for larger clients' (Reynolds and Francis, 2001:397). In fact, the evidence provides support for the accounting profession's argument that 'reputation protection' (Reynolds and Francis, 2001:396) is enough of an incentive to keep the auditor honest. Reynolds and Francis (2001) argue that larger clients are often high profile and so, in fact, the auditors may be more conservative due to the extent of potential loss of reputation and greater exposure to legal liability.

Craswell et al. (2002) examine real auditor independence in relation to fee dependence. They measure an auditor's propensity to issue unqualified audit opinions in relation to audit fees, using publicly available Australian information from 1989. Craswell et al. (2002) find no evidence of fee dependence either at a national or a local market level. Moreover, Higgs and Skantz (2006) argue that companies who pay very high audit fees are actually signalling audit quality to investors, giving investors greater faith in the company's audited financial statements. However, Khurana and Raman (2006), using cost of equity capital as a proxy for investor perceptions of the credibility of financial reports, find that higher fees damage investor perceptions of auditor independence.

The literature in this area highlights that in the face of large audit fees third parties need further reassurance that auditor independence exists. However, much of the UK perceptions-based work was conducted in the 1980s and 1990s, in an audit environment which is very different from the present days. An up to date account of how economic dependence is perceived will be provided by the current research.

It is noted that the combination of audit and non-audit work could cause a conflict of interest for auditors (Firth, 1980:463). Audit fees and non-audit service fees combined could cause a level of economic dependence, which would have an effect (consciously or unconsciously) on an auditor's unbiased mental attitude.

Non-Audit Service Provision

Of the three auditor-client relationships explored in this study, the joint provision of audit and non-audit services is by far the most controversial. In 1961, Mautz and Sharaf advised that the only way for auditors to maintain an appearance of independence was to engage in auditing alone. More recently, Clikeman (1998:41) has argued that accountants need ‘different mindsets’, a consultant is required to be an ally of management, whilst an auditor is required to maintain a professional detachment from management. In 2002, Beattie and Fearnley conducted a substantial review of the wealth of non-audit service literature. In this review two main concerns relating to auditor independence were highlighted. Firstly, that auditors may be too concerned with safeguarding the additional income from non-audit services to stand up to management and, secondly, providing additional services might cause auditors to lose professional scepticism and ‘identify too closely with management’ (Beattie and Fearnley, 2002:ix).

The highly divisive topic of non-audit service provision has been explored in many different ways, Church and Schneider (1993) designed their study to determine whether an auditor’s prior involvement in the design of an audit programme impaired his or her objectivity when making subsequent decisions relating to that programme. The results of their experiment showed that ‘the auditors’ role in audit programme design was associated with a lower search time for errors/irregularities in the account relating to that audit programme’ (Church and Schneider, 1993:74). However, Plumlee (1985:699) contends that, notwithstanding the self-review threat, it is

important that auditors charged with reviewing a client's internal systems have detailed knowledge of such systems.

Some commentators have attempted to determine the effect of joint provision by comparing audit or going concern decisions with the level of non-audit services provided. Wines (1994) reported that those companies which did not receive qualified audit opinions paid more in non-audit services than companies receiving at least one audit qualification (see also Firth, 2002). In contrast, Barkess and Simnett (1994) found an insignificant relationship between the type of audit report and the level of non-audit services provided (see also Craswell, 1999). However, Sharma and Sidhu (2001) found that auditors receiving high non-audit fees from a client were less likely to issue a going-concern qualification to that company than companies who did not purchase non-audit services. DeFond et al. (2002) report that 'contrary to regulators' concerns we find no association between non-audit service fees and the auditors' propensity to issue a going-concern opinion' (DeFond et al., 2002:1271). Instead, DeFond et al. (2002) argued that market-based incentives such as the risk of reputation loss and litigation costs are enough to keep an auditor independent. DeFond et al. (2002) concluded that the SEC regulations concerning restrictions on non-audit service provision were not necessary (see also Geiger and Rama, 2003).

As noted in Beattie and Fearnley (2002), certain studies have suggested that the provision of non-audit services can make the auditor *more* objective (see Goldman and Barlev, 1974). Corless and Parker (1987) attempted to measure real independence by examining auditors' independent behaviour. 181 auditors were given a case study and asked to evaluate the internal controls of the company described in the case.

Corless and Parker (1987) hypothesised that the auditors who had been told that their firm had helped to design and implement the system would rate it as stronger than those auditors who were told that a different company had designed and implemented the system. The purpose of the research was to determine whether non-audit services provided by a representative of the audit firm influenced the opinions of the auditors who later had to review this work. However, those respondents who had been told that their own firms were involved in the design of the client's internal control system were more critical of the system than those who were told another firm had designed it (see also Davidson and Emby, 1996). Jenkins and Krawczyk (2001:73) believe that audit firms who provide non-audit services to the same clients are increasing their 'uniqueness' to that client, meaning that the client is dependent upon the audit firm thus putting the audit firm in a stronger position to resist client pressure. Furthermore, Hussey and Lan (2001:3) argue that despite concerns over non-audit services, an outright ban would 'increase client costs, reduce efficiency and place restrictions on the freedom of the client to make decisions on the services they desired'.

Beattie and Fearnley (2002) note the conflict between studies such as Schulte (1965), Briloff (1966), Hartley and Ross (1972), Lavin (1976), Firth (1980) and Shockley (1981) which indicate early concern over joint provision of audit and non-audit services and those of Titard (1971), Pany and Reckers (1988) and Gul (1989) which argue that non-audit service provision does not damage perceptions of auditor independence. Current studies show that the debate over non-audit service provision is no nearer resolution.

In a UK-based study examining perceptions of certain economic and regulatory factors which could affect independence, Beattie et al. (1999) found that whilst non-audit service provision was a general concern, financial statement users were more worried than audit partners. Canning and Gwilliam (1999), in a study of Irish lenders, investment managers and financial analysts, and Quick and Warming-Rasmussen (2005), in a Danish study of investors, lenders and auditors, reported similar perceptions to Beattie et al. (1999). Abbott et al. (2003) reported that active and independent audit committees were less willing to purchase non-audit services from their companies' auditors. Lindberg and Beck (2004), in a survey of CPAs, found that the Enron collapse had increased practitioners' concerns about the threat to audit independence caused by non-audit services.

As the review of the literature in this area highlights, there is little consensus about the effect of non-audit service provision on auditor independence. The current study will respond to Krishnan et al's. (2005:114) call for more research in this area by providing a post-Enron account of UK investor perceptions of those non-audit services banned under the Sarbanes-Oxley Act (2002). Currently, the APB (2008) standards do not heavily regulate non-audit service provision; this study will give an indication of how well protected UK investors perceive themselves to be.

Long Tenure

It has been argued that auditors may become less challenging over time, causing the audit process to become 'stale' (Brody and Moscovice, 1998:33) and that a system of audit firm rotation would result in better audit quality, as new auditors provide a

‘fresh perspective’, overcoming the problem of familiarity (ICAEW, 2002:3). However, opponents of mandatory audit firm rotation argue that auditor independence is more likely to be impaired in the early years of the relationship, as auditors try to recover their initial start up costs and have no specific knowledge of the client.

Many studies in this area examine the effect that length of tenure has upon ‘real’ auditor independence. Most commonly these studies have compared the length of auditor-client relationship to compliance with professional standards or to fraudulent financial reporting or to measures of audit quality. By examining factors associated with lawsuits filed against accountants, St. Pierre and Anderson (1984) were among the first to argue that audit risk is highest when the auditor has three or fewer years experience of the client company. More recently these findings have been confirmed by studies such as Johnson et al. (2002) and Geiger and Raghunandan (2002), who argue that audit quality is most at risk when client-specific knowledge is lowest. Similarly, Carcello and Nagy (2004) find a positive association between fraudulent financial reporting and short audit tenure and Jenkins and Velury (2008) find that conservatism in reported earnings is lower in the early years of auditor-client relationships. Furthermore, in a study of capital market participants, Ghosh and Moon (2005) report that financial analysts relied more heavily on recent reported earnings when making forecasts about future earnings as the auditor-client relationship lengthens. In general, these studies provide evidence against the introduction of mandatory audit firm rotation. However, evidence provided by Deis and Giroux (1992), Coupley and Doucet (1993), Nagy (2005) and Carey and Simnett (2006) suggests that audit quality declines as the length of tenure increases and that new auditors are more sceptical in their outlook. Moreover, in an experimental study,

Dopuch et al. (2001) find that audit reports biased in favour of client management are most frequent when no system of mandatory audit firm rotation is in place.

The ICAEW (2002:12) argues that mandatory audit firm rotation would provide a better appearance of auditor independence, which 'is arguably just as important [as independence in fact]' (ICAEW, 2002:12).

Firth (1980) reports the findings of a survey of users (including investors and stockbrokers) and preparers of financial statements in order to determine perceptions of 29 different auditor-client relationships. The respondents were asked to indicate their perceptions of auditor independence in a situation where the audit partner had been in sole charge of a large audit for the past 10 years. The majority of both the users and the preparers of financial statements indicated that the 10 year auditor-client relationship did not impair their perceptions of auditor independence. Firth (1980) argued that often the benefits of such relationships are overlooked, such as the audit being completed with increased expertise. In a subsequent study, Firth (1981) argued that a long relationship between auditor and client would mean audits being completed more quickly, a reduction in audit fees and greater auditor expertise. In the 1981 study, bank loan officers were asked to make a lending decision based on a company who had employed the same auditor for 10 years. The results showed that long auditor tenure did not reduce loan offers nor did it adversely affect bank loan officers' confidence.

Shockley (1981) obtained opinions from the (then) Big Eight partners, local and regional firms, commercial loan officers and financial analysts of the effects of long

tenure on auditor independence. He hypothesised that auditors who had performed a given client's audit for a period longer than five years would be perceived as having a greater risk of losing independence than auditors who had a shorter tenure. He found a general consensus that 'an audit firm's tenure with a given client is not significant' in determining an auditor's independence (Shockley, 1981:785).

In contrast, Knapp (1991) found that audit committee members' perceptions of audit quality were positively correlated with five-year tenure, but negatively correlated in subsequent years. Knapp (1991:47) argued that audit committee members perceived a learning curve effect in the early years of the relationship which gradually improves quality, but 'complacency on the part of the auditor, over-reliance on the client and less rigorous audits may account for the erosion of perceived audit quality as audit tenure becomes relatively lengthy'.

In a questionnaire-based study of users and preparers of financial statements in Barbados, Alleyne and Devonish, (2006:628) found that a 10 year auditor-client relationship did impair perceptions of auditor independence and that rotation of audit partners every 7 years was 'identified as highly important in promoting auditor independence'. In a similar vein, Bakar et al., 2005, found that the majority of Malaysian loan officers sampled agreed that the longer the auditor-client relationship, the greater the likelihood that independence would be impaired. Baker et al. (2005) argued that any attempt to reduce the length of auditor-client tenure (such as mandatory audit firm rotation) would have a strong positive effect on auditor independence perceptions. However, in a UK-based study of finance directors,

Hussey and Lan (2001) found that the overwhelming majority (60%) were not in favour of compulsory audit firm rotation.

The studies in this area are very much divided over the effects of long tenure on auditor independence and thus the quality of audits. From the perceptions-based studies, there is no evidence on how UK investors perceive long tenure or how they view the question of mandatory audit firm rotation.

Hypotheses

While the existing literature appears to offer contradictory explanations about the effect of economic dependence, non-audit service provision and long tenure upon auditor independence, the current paper starts with the a priori assumption that each of the auditor-client relationships will negatively impact upon auditor independence perceptions:

H1a: Investor perceptions of auditor independence will be negatively affected by the economic dependence of the auditor on the client company.

H1b: Investor perceptions of auditor independence will be negatively affected by an auditor's joint provision of audit and non-audit services to a client company.

H1c: Investor perceptions of auditor independence will be negatively affected by client employment of the same auditor for over 5 years.

In addition to these main hypotheses, certain background variables will be examined for their affects upon perceptions of auditor independence. The following hypotheses are stated in their null forms:

Accounting education was first tested by Reckers and Stagliano (1981) who suggested that those expressing the greatest apprehension about auditor independence would be those who did not understand the audit function. Reckers and Stagliano (1981) argued that greater accounting education could help to reduce concerns about auditor independence. However, Pany and Reckers (1983; 1984) and Bartlett (1993) have rejected the assumption that accounting education affects perceptions of auditor independence.

H2: There is no difference between investors with and investors without accounting qualifications in their perceptions of auditor independence.

It is expected that differences will be detected in the auditor independence perceptions of two groups of investors (institutional and private). Titard (1971) suggested that institutional investors may be more concerned about the issues relating to auditor independence than private shareholders because institutional investors buy shares for thousands of investors and so their decisions will be of greater significance than those made by private investors. However, it could also be argued that private investors may be more concerned about auditor independence issues than institutional investors as private investors stand to lose their own money (and income) through making a poor investment decision.

H3: There is no difference between institutional and private investors in their perceptions of auditor independence.

A number of researchers (Hudgens and Fatkin, 1984, Zinkhan and Karande, 1991, Powell and Ansic, 1997, and Levin et al., 2001) have suggested that in business and financial situations, women are more risk-adverse than men are. However, Masters (1989) suggests that there is no difference between men and women in decision-making and risk-taking. The current paper will attempt to determine whether gender affects perceptions of auditor independence.

H4: There is no difference between men and women in their perceptions of auditor independence.

Pany and Reckers (1983) have suggested that larger investors and institutional investors may be more concerned about auditor independence issues than smaller institutional investors and private shareholders. This is because the decisions, which the larger institutional investors make, are in the public eye and will receive greater attention. Size of investment portfolio will be examined to determine its effects upon perceptions of auditor independence.

H5: There is no difference between investors with large and small investment portfolios in their perceptions of auditor independence.

It is suggested that those investors who indicate that they have previously been auditors and now work for their client company, might view the three auditor-client

relationships more positively than other investors. Previous studies show that auditors are normally more confident in their own ability to remain independent than third parties such as investors (Imhoff, 1978, Firth, 1980, Lindsay et al., 1987, Bartlett, 1993, Beattie et al., 1999 and Quick and Warming-Rasmussen, 2005). Furthermore, those who have previously been auditors could themselves have experienced a situation of economic dependence, non-audit service provision or long tenure, this experience should be controlled for.

H6: There is no difference in their perceptions of auditor independence between those who have previously been auditors and those who have not.

For the reasons stated above, employment history within accounting firms will also be tested for effects upon auditor independence perceptions.

H7: There will be no differences in perceptions of auditor independence between those who have previously worked in a big 4 firm, those who have previously worked in a small/medium sized accounting firm and those who have had no experience of working in an accounting firm at all.

The hypotheses development results in the following model which will be explored using multiple regression analysis :

$$\text{Auditor Independence Perceptions} = a + \beta_1 \times \text{QUALIFICATION} + \beta_2 \times \text{TYPE} + \beta_3 \times \text{GENDER} + \beta_4 \times \text{PORTFOLIO} + \beta_5 \times \text{EX-AUDITOR} + \beta_6 \times \text{FIRMEXP} + e$$

Where:

QUALIFICATION = whether the respondent possesses an accounting qualification

TYPE = whether the respondent is a private or institutional investor

GENDER = the respondent's gender

PORTFOLIO = the size of the respondent's investment portfolio

EX-AUDITOR = whether the respondent has previously been an auditor

FIRMEXP = whether the respondent has experience of working in an accounting firm

Method and Sample Selection

As the owners of organisations and the main users of financial statements, investors were the sample selected for investigation. Investors put their faith in auditors to report whether financial statements present a true and fair view. Thus, it is essential that investors perceive auditors to be in an independent position.

A pilot questionnaire was sent to a small group of institutional investors in 2004. This pilot was important in informing the format and subject matter of the current questionnaires, highlighting a number of areas that needed to be addressed. For example, the pilot focused almost exclusively on investor perceptions of the provision of non-audit services. However, many respondents had annotated their questionnaires with other factors which they perceived to be independence-impairing. As a result, the auditor independence literature was revisited and the current questionnaires were extended. Further changes included a broadening of the Likert scale from three points to five points and a shift in emphasis from open-ended questions to closed questions.

Once constructed the questionnaires were further revised in light of advice and suggestions from colleagues.

The questionnaires varied slightly between the private and institutional investor sample in order to acknowledge the differences between the two samples. In order to maximise response rates the questionnaires were kept short, a covering letter was included and the respondents were guaranteed confidentiality. The institutional investors were sent two follow-up reminders and the private investors were contacted once by way of follow-up.

The final version of both questionnaires were divided into four sections, each section addressing one of the research questions with the final section focussing on respondent characteristics. In general the exact wording of each of the questions included in the final version of the questionnaires were original in nature, questions which were based upon previous studies are highlighted in the following discussion.

The first section of the questionnaire addresses the research question examining perceptions of economic dependence. Few studies have focused on the issue of audit fees alone causing economic dependence, most tending to consider the provision of non-audit services as a greater threat to auditor independence. Gul (1991) argues that there is a need for research which determines whether the size of audit fees alone could damage perceptions of auditor independence, regardless of the provision of non-audit services. Questions in this section aim to uncover whether investors consider how much a client pays to its auditors, in terms of total audit firm income and whether investors would invest in a company if they perceived its auditors to be

dependent upon it. A question is also included to respond to Beattie and Fearnley's (2002) arguments that the APB should reduce the level of proportionate income which one company is allowed to pay to its auditor from 10% to below 5%. Respondents are asked to indicate the point at which fees paid by one client to the auditor would start to concern them. Section one addresses hypothesis H1a.

Section two addressed the research question examining the issue of non-audit service provision. Many of these questions were taken directly from the pilot study. Respondents were asked whether they considered the level of non-audit services provided by the auditor before investing in a company and whether the provision of non-audit services by an auditor would affect investors' confidence in independence. Perceptions of the Big 4 audit firms were also examined. McKinley et al. (1985), Gul (1989), Oxera (2006) and London Economics (2006) suggest that third parties have more confidence in the large firms than smaller ones.

Investor perceptions of individual non-audit services are also explored. Titard (1971) was one of the first studies to treat non-audit services individually. Krishnan et al. (2005) acknowledged that treating non-audit services in an aggregate form might have been a limitation of their research. Furthermore, Mishra et al. (2005) find evidence to suggest that investor perceptions of different non-audit services vary. This question was designed to help identify whether UK investors believe that the non-audit services banned under the Sarbanes-Oxley Act (2002) in the USA should also be banned in the UK.

Finally, institutional investor perceptions of the regulations on the provision of non-audit services are investigated. Auditor independence enhancement strategies have often been ignored in the academic literature (Beattie et al., 1999 and Alleyne and Devonish 2006). Perceptions of current and suggested safeguards are explored. Many of the safeguards listed in the question were suggested by the Association of British Insurers in a paper written after the Enron collapse (ABI, 2002). The questions in this section are intended to address hypothesis H1b.

The third section addressed the research question examining investor perceptions of long (over 5 year) auditor-client relationships. A period of five years was chosen to represent a lengthy auditor-client relationship, as currently in the UK audit engagement partners are required to rotate every five years. Furthermore, Knapp (1991) discovered that audit committee members perceived audit quality to rise until the fifth year of the relationship, whereupon they perceived audit quality to decline. In this section investors are asked whether long tenure would damage their perceptions of auditor independence and what their optimum length of auditor-client relationship would be, i.e. the point at which he or she would view the length of relationship as becoming independence-impairing. Investors were also asked whether they perceived the APB's (2004) recommendation for partner rotation every 5 years as being a sufficient safeguard against the risks of long tenure or whether they would like to see mandatory audit firm rotation introduced. This is an important question as the literature is divided over whether audit firm rotation would be the best safeguard against the risks of long tenure or whether audit quality is lowest in the early years of an auditor-client relationship. Those in favour of mandatory audit firm rotation were also asked to explain their position, the suggested reasons in favour of such a system

were taken from existing literature such as Taub (2004), ICAEW (2002), Arrunada and Paz-Ares (1997) and Hoyle (1978). Section three of the questionnaire addresses hypothesis H1c.

The final section of both questionnaires asked respondents for personal information such as their age, gender and whether or not they possessed accounting qualifications.

Since no complete list of institutional investors exists, a random sample of the entire population was not feasible for the current study. Instead, 719 names and addresses of UK institutional investors were selected at random from various databases of insurers, banks, building societies, fund managers, pension funds and investment trusts and their chief executives were mailed a copy of the questionnaire. The databases used to acquire names and addresses included that of the Association of British Insurers, the Investment Management Association, the Association of Investment Trust Companies, the British Bankers Association, the Building Societies Association and the Council of Mortgage Lenders. Furthermore, various on-line lists of fund managers and investment trusts were provided by the Financial Times, Find.co.uk, Finance Link and Financial Express. The sample drawn represents a wide range of institutional investors.

In order to provide a point of comparison with institutional investors' perceptions, private investors were also targeted. The registers of members for Amstrad PLC and Jarvis PLC were obtained from Companies House. A random sample of 460 names (excluding companies, institutional investors and nominee shareholdings) was taken for each company.

Response Rates and Tests for Bias

The questionnaires were sent out to the investors over the Summer of 2005. Two follow-up letters (one with and one without an additional copy of the questionnaire) were sent to the institutional investors and one follow-up letter was sent to the private investors. The resultant overall, usable, response rate for both samples combined was 22%, (or separately, 16% for institutional investors and 28% for private investors).

The results were tested for non-response bias using the approach advocated by Oppenheim (1966) and Wallace and Mellor (1988) which takes late responses as a surrogate for non-responses. A chi-square test was used to compare the responses to the main questions in each section between the early and late respondents. No statistically significant relationship was found. Further analysis using t-tests confirmed the previous result and found no statistically significant difference between the perceptions of the early and late respondents for either the private or the institutional investors. These tests indicate that the survey was not subject to non-response bias.

Measuring Perceptions of Auditor Independence: Results

Table 1 outlines respondent characteristics. Institutional investors were predominantly male (93.8%) and between the ages of 41 and 60 years old. 58.4% claimed to possess an accounting qualification; of those qualifications, 95% were financial accounting qualifications, whilst only 5% were management accounting qualifications. 47.8% of the sample had experience of working within one of the Big Four accounting firms

and 14.2% of the respondents had once been an auditor and then moved to a client company.

Of the private investor respondents, 78.7% were male, with the majority over 60 years old. Only 15.1% of the sample possessed accounting qualifications (85% financial and 15% management accounting qualifications) and 85.7% of the sample had no experience of working within an accounting firm at all. Only 1.6% claimed to have once been an auditor and then to have moved to a client company.

Descriptive Analysis

The results of the descriptive analysis can be found in Table 2. In terms of perceptions of economic dependence, the majority of both groups of investors indicated that economic dependence was a threat to auditor independence. 53.1% of the institutional investors indicated that they would not invest in a company if they perceived the auditors to be dependent upon that company for a large amount of income. Furthermore, 57.1% of the institutional investors indicated that they did not believe that it was possible for an auditor to remain independent if it was economically dependent upon one client. However, institutional investors were divided over whether audit fees alone could cause a threat to auditor independence, 38% of the respondents argued that auditors would not risk impairing independence for audit fees alone whilst 40% of the respondents shared Gul's (1991) view that audit fees could be large enough to threaten auditor independence. Similarly, of the private investors, the majority (67.8%) indicated that they would not invest in a company if they perceived the auditors to be economically dependent upon it. Moreover, 55.6% of the private

investors agreed that an auditor who is economically dependent upon a client will not be able to remain independent.

In examining regulations on auditors, 74.1% of institutional investors perceived the 10% limit on fees from a listed client as a sufficient safeguard of auditor independence. However, like Beattie and Fearnley (2002), 78.9% of the dissenters called for a reduction in the limit in order better to protect auditor independence.

In light of these findings, hypothesis H1a is accepted as economic dependence does negatively affect investor perceptions of auditor independence.

In a similar vein to the perceptions of economic dependence recorded, the majority of both groups of investors indicated that the provision of non-audit services caused concern in relation to auditor independence. 42.9% of institutional investors indicated that the joint provision of audit and non-audit services impaired their perceptions of auditor independence, with 42.1% of private investors taking the same view. In examining the non-audit services banned under Sarbanes-Oxley, it appears that institutional investors perceive internal audit services, valuation of assets and liabilities, investment advice, bookkeeping and actuarial services to pose the greatest threat to auditor independence. Those services which caused the least concern were tax services, human resources, expert and legal services and information systems design and implementation.

The results indicate that hypothesis H1b should be accepted, as the joint provision of audit and non-audit services impairs auditor independence perceptions.

Institutional investors were asked to indicate at what point the percentage of non-audit fees out of total fees paid to a particular client would become a threat to auditor independence. However, there was little consensus in the results: 19.3% indicated 11-20%, 10.1% of the sample indicated greater than 70%, and 8.3% of the sample indicated less than 10%.

Interestingly, 32.2% of institutional investors indicated that they would have confidence in the independence of a Big Four accounting firm providing non-audit services to a client company but only 21.4% expressed confidence in smaller firms' independence. However, 29.5% of institutional investors indicated that they would not be confident for Big Four accounting firms jointly to supply audit and non-audit services.

Safeguards for auditor independence were also considered. The majority of both sets of investors indicated that there should be a ban on audit personnel providing non-audit services, but that there should not be a ban if a separate division of the same firm provides the non-audit services. Both institutional and private investors indicated that if a ban on non-audit service provision were to be introduced, it should take the form of professional rules rather than law, suggesting that investors still trust the accounting profession to regulate itself.

Alternatives to a ban on non-audit service provision were put to the institutional investors. The majority of the respondents indicated that they would not be in favour of regulations that would 'strait-jacket' company decisions. The least preferable of the options was putting non-audit work out to tender, which respondents argued would be

too hard to police, would be too costly or would slow down company decision-making. Interestingly, the institutional investors were also not in favour of giving shareholders greater power to intervene in the governance of companies. The reluctance to be more active could be due to fear of assuming more responsibility and liability. The respondents cited reasons for their opposition to such a policy as:

- *'Shareholders should remain divorced from the management of the company'*
- *'Company directors are in a better position to make decisions about the governance of the company'*
- *'It would lead to economic stagnation which we have seen in Germany for the last 10 years through workers councils'.*

Institutional investors favoured lower cost options such as strengthening audit committees and greater disclosure in annual reports of the need for non-audit services.

Finally, perceptions of long tenure were explored. The majority of both institutional and private investors (48.6% and 38.4%, respectively) agreed that a relationship between auditor and client of over 5 years was not a threat to auditor independence. However, the results appear to suggest that private investors are more concerned about long tenure than institutional investors as only 18% of institutional investors agreed that long tenure was a threat, compared to 26.4% of private investors. Both groups of investors indicated that they perceived the current regulations of partner rotation to be sufficient in protecting auditor independence. However, almost half of the private investors were proponents of mandatory audit firm rotation as a means for greater protection of investments, once again highlighting private investor concerns.

Institutional investors stated that the system of mandatory audit firm rotation would cause too much disruption and that the start-up costs would be too great. Other arguments against the introduction of mandatory audit firm rotation were that there is a greater audit risk in the early years of an auditor-client relationship and that there are not enough audit firms in the market to support mandatory audit firm rotation. However, of the institutional investors who indicated that mandatory audit firm *should* be introduced, 29.2% argued that this rotation should take place after the audit firm has been in place for 5 years whilst 43.8% indicated rotation should take place between 6-10years after the audit firm is appointed.

In light of these findings, hypothesis H1c is rejected: long tenure does not appear to affect the majority of investors' perceptions of auditor independence.

Exploring Relationships

Multiple regression analysis was conducted to test whether the factors identified in Hypotheses 2 to 7 affected perceptions of auditor independence. The results are displayed in Table 3.

In the first instance a variable of 'auditor independence perceptions' was created. This variable was the sum of the responses to the main questions on each of the auditor-client relationships (which proved to be positively correlated). Combining these responses created a 'scale' of auditor independence concerns for each individual, with high scores representing more concern for the three auditor-client relationships than low scores. Multiple regression analysis was then employed to test for relationships

between this auditor independence scale and the 6 independent variables which were: QUALIFICATION, TYPE, GENDER, PORTFOLIO, EX-AUDITOR and FIRMEXP.

The results show that, whilst the overall model had low explanatory power (R Square of .132), it was significant. In the case of GENDER, PORTFOLIO, EX-AUDITOR and FIRMEXP, it appears that the null hypotheses are confirmed as no significant relationships were uncovered. However, in the case of QUALIFICATION, a significant negative relationship was detected. This suggests that those who do not have accounting qualifications are the most concerned about auditor independence. This confirms the earlier findings of Reckers and Stagliano (1981). Therefore, H2 is rejected, as there are differences in investor perceptions as a result of possession of accounting qualifications.

TYPE was also revealed to be negatively and significantly associated with auditor independence. Private investors may be more concerned about independence issues as they invest their own money and thus stand to lose substantially more of their income in the event of company failure. Furthermore, fewer of the private investors have accounting qualifications, so this finding could be related to the QUALIFICATION finding. H3 is rejected as there are differences between private and institutional investors in their perceptions of auditor independence.

In order to test for the reliability of the 'auditor independence scale', those relationships revealed as significant were then tested against the three individual auditor-client relationships separately, using ANOVA, to confirm the findings. These results are outlined in Table 4.

For the QUALIFICATION variable, the results show that for the institutional investors there was no statistically significant differences in their mean concern for economic dependence, non-audit services and long tenure, between those with or without accounting qualifications. However, private investors without accounting qualifications had a higher mean level of concern than those with accounting qualifications. One explanation for QUALIFICATION's lack of effect upon institutional investors' perceptions could be that even those who indicated that they had no accounting qualifications may still have had a good understanding of accounting in their position as chief executive.

The ANOVA performed upon the TYPE variable confirmed that for economic dependence and long tenure, the private investors had a statistically significantly higher mean level of concern regarding independence than the institutional investors.

Conclusion

The current findings reported above are consistent with those of Firth (1980; 1981) and Beattie et al. (1999).

A review of the academic literature and current UK regulations highlighted that economic dependence, non-audit service provision and long tenure had the potential to damage auditor independence. The results show that UK investors are most concerned about the threats of economic dependence and non-audit service provision and relatively unconcerned about the threat of long tenure. In general, tests revealed

that private investors were more concerned about the auditor-client relationships than the institutional investors. Moreover, the institutional investors indicated that they were satisfied with the current regulations to prevent threats to independence and would not be in favour of bans or tighter regulations which would 'strait-jacket' company decisions.

This study has provided an original comparison of UK institutional and private investor perceptions of three controversial auditor-client relationships. The study has also provided a timely investigation into investor perceptions of UK auditing regulations. As investors are one of the main users of audited financial information, it is important that they perceive auditors to be independent. Without such confidence, a return to more stable economic conditions is likely to lie much further in the future.

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Table 1 Respondent Characteristics

Characteristics	Institutional Investors	Private Investors
	%	%
Male	93.8	78.7
Female	6.2	21.3
With Accounting Qualifications	58.4	15.1
Of those: Financial Accountants	95	85
Of those: Management Accountants	5	15
Without Accounting Qualifications	41.6	84.9
Experience in Accounting Firms: None	38.9	85.7
Experience in Accounting Firms: A Small Firm	5.3	4.8
Experience in Accounting Firms: A Medium Firm	8	3.6
Experience in Accounting Firms: Big Four	47.8	6
Age- Under 30 yrs	3.5	0.4
Age- 30-40 yrs	23.9	7.2
Age- 41-50 yrs	30.1	13.5
Age- 51-60 yrs	38.9	27.5
Age- Over 60 yrs	3.5	51.4
Undertaken a Personnel Transfer	14.2	1.6
Not Undertaken a Personnel Transfer	85.8	98.4
Company Employs < 100	44	
Company Employs 100-250	18	
Company Employs 251-500	10	
Company Employs > 500	28	
Mean Number of Companies Invested in:	259.75	24

Table 2 Descriptive Statistics

	Institutional Investors			Private Investors		
	Yes	Neutral	No	Yes	Neutral	No
Would investors invest if they perceived the auditor to be economically dependent upon their chosen company?	20.7	26.1	53.1	5.2	22.6	68.3
Do investors believe that an auditor can be economically dependent upon a client but still retain independence?	27.7	15.2	57.2	25.4	19	55.6
Do investors believe that audit fees alone can damage auditor independence?	40.2	21.4	38.3			
Do institutional investors perceive the 10% income limit as an adequate safeguard?	74.1	12.5	13.4			
Do investors perceive non-audit services as a threat to auditor independence?	42.9	26.8	30.4	42.1	39.4	18.5
Are investors confident of the independence of Big 4 auditors?	32.2	38.4	29.5			
Are investors confident of the independence of smaller auditors?	21.4	36.6	42			
Should non-audit services be banned if audit personnel provide them?	59.8	6.2	33.9	59.3	14.2	26.5
Should non-audit services be banned if different personnel provide them?	11.6	5.4	83	23.7	20.9	55.3
Should a ban be by law?	12.7			40.8		
Should a ban be by professional rules?	85.9			52		
Would be in favour of a prescribed ratio of audit to non-audit fees?	31.5	18	50.5			
Would be in favour of strengthened audit committees?	71.2	17.1	11.7			
Would be in favour of putting non-audit work out to tender?	27.9	18	54.1			
Would be in favour of better justification in the annual report of the need for non-audit services?	58.6	18	23.4			
Would be in favour of greater shareholder power?	20.9	26.4	52.7			
Do investors perceive long association as a threat to auditor independence?	18	33.3	48.6	26.4	35.2	38.4
Is partner rotation a sufficient safeguard?	70.5	2.7	20.5	68.4	8.3	15
Should mandatory audit firm rotation be introduced?	34.8	8	57.1	49.4	14.2	36.4

Table 3 Results of Multiple Regression Analysis

Independent Variable	Standardised Coefficients – Beta	t	Sig.
QUALIFICATION	-.208	-3.053	.002*
TYPE	-.162	-2.369	.018*
GENDER	-.025	-.460	.646
PORTFOLIO	-.080	-1.324	.187
EX-AUDITOR	.040	.692	.489
FIRMEXP	-.019	-.263	.793

* Significant at 0.05 level

Table 4 ANOVA Results

	INSTITUTIONAL INVESTORS			PRIVATE INVESTORS		
	Mean	Std. Deviation	Sig.	Mean	Std. Deviation	Sig.
ECONOMIC DEPENDENCE:						
QUALIFICATION - Yes	3.39	1.021	.932	3.45	1.005	.013*
QUALIFICATION - No	3.38	.912		3.75	.904	
NON-AUDIT SERVICES:						
QUALIFICATION - Yes	3.09	.972	.558	3.00	1.065	.045*
QUALIFICATION - No	3.20	.859		3.30	.880	
LONG TENURE:						
QUALIFICATION – Yes	2.56	.879	.728	2.46	1.120	.010*
QUALIFICATION - No	2.62	.960		2.93	.995	
COMBINED DATASET						
ECONOMIC DEPENDENCE:						
INSTITUTIONAL	3.39	.974	.004*			
PRIVATE	3.70	.921				
NON-AUDIT SERVICES:						
INSTITUTIONAL	3.13	.925	.256			
PRIVATE	3.25	.911				
LONG TENURE:						
INSTITUTIONAL	2.59	.909	.019*			
PRIVATE	2.85	1.025				

* Significant at 0.05 level